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# DEFENSE WORKING CAPITAL FUND

# Improvements Needed for Managing the Backlog of Funded Work

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Congressional Committees

Section 1051 of the National Defense Authorization Act For Fiscal Year 2001 (Public Law 106-398) requires that we review the working capital fund activities of the Department of Defense (DOD) to (1) identify any potential changes in current management processes or policies that, if made, would result in a more efficient operation and (2) evaluate various aspects of the DOD policy that allow Defense Working Capital Fund activities to carry over a 3-month level of work from one fiscal year to the next. This report is the first in a series of reports that responds to this requirement and addresses the working capital fund fiscal year-end workload funding issue generally referred to as "carryover."

According to DOD's fiscal year 2001 budget estimates, working capital fund industrial activities will have about $7 billion of funded work that will be carried over from fiscal year 2001 into fiscal year 2002.[1] The congressional defense committees recognize that these industrial activities need some carryover to ensure a smooth flow of work during the transition from one fiscal year to the next. However, past congressional defense committee reports raised concerns that the level of carryover may be more than is needed for this purpose. Excessive amounts of carryover financed with customer appropriations are subject to reductions by DOD and the congressional defense committees during the budget review process. To the extent that carryover is high, the Congress may redirect the funds gained from such reductions to other priority initiatives.

This report assesses the working capital fund policies and practices related to carryover. Specifically, our objectives were to review (1) the basis for DOD's 3-month carryover policy, (2) the military services' implementation of this policy, (3) the military services' budgeted versus reported actual carryover amounts and whether there were any instances when the reported year-end carryover exceeded the 3-month policy, and (4) the potential financial and operational impact of reducing the amount of permitted carryover.

[1]The carryover amount includes work for which obligations have been made but which has not yet started and the cost to complete work that has been started.

We limited the scope of our review to selected depot maintenance, research and development, and ordnance activity groups because their budget reports show that they will have the most carryover at the end of fiscal year 2001. DOD's budget estimates that these activity groups will have about $6.3 billion of carryover at the end of fiscal year 2001—about 90 percent of the Defense Working Capital Fund's $7 billion total carryover. Our review was performed from September 2000 through April 2001 in accordance with U.S. generally accepted government auditing standards. However, we did not validate the accuracy of the accounting and budget information referred to in this report, all of which was provided by DOD. Further details on our scope and methodology can be found in appendix I. DOD comments on a draft of this report are reprinted in appendix III.

## Results in Brief

DOD does not have a sound analytical basis for its current 3-month carryover standard. DOD established a 3-month carryover standard for most working capital fund activity groups,[2] although it has not performed the analysis necessary to support the 3-month standard. DOD officials informed us that the 3-month standard was based on management judgment and has been in effect for many years. Without a validation process, however, neither DOD nor congressional decisionmakers can be assured that the 3-month standard is achieving its intended goal of providing activity groups with reasonable amounts of carryover to ensure a smooth transition from one fiscal year to the next or whether the carryover is excessive. Because the activity groups perform different types of work and have different business practices, the use of the same carryover standard for all activity groups is likely not appropriate.

In addition, carryover information currently reported under the 3-month standard is not comparable between services and is misleading to DOD and congressional decisionmakers. Specifically, because the military services use different methods to calculate the number of months of carryover, their results can differ markedly. For example, in developing the fiscal year 2001 budget, the Navy calculated its carryover balance using adjustments that reduced its reported year-end carryover balance for some

[2]The 3-month standard applies to all activity groups except for Air Force contract depot maintenance operations, for which DOD established a 4.5-month carryover standard.

activity groups by 2 to 4 months. The Army's methodology involved adjustments that reduced its reported year-end carryover balance by less than 1 month. The Air Force's year-end carryover balance was not affected because it did not make any adjustments. Because the Navy's adjustments significantly lowered its reported year-end carryover balances and reduced them to less than 3 months, the Congress did not reduce the Navy's budget.[3] On the other hand, because the Army's adjustments were minimal (less than 1 month) and the Air Force did not make any adjustments, some of their activity groups' year-end carryover balances exceeded the 3-month standard. As a result, the Congress reduced the Army's appropriation by $40.5 million and the Air Force's appropriation by $52.2 million.

Further complicating the congressional budget review of carryover is that some activity groups have underestimated their budgeted carryover year after year, thereby providing decisionmakers with misleading year-end carryover information and resulting in more funding being provided than was intended. Specifically, since fiscal year 1998, the Army depot maintenance and ordnance activity groups and the contract portion of the Air Force depot maintenance activity group have frequently budgeted for carryover balances to be less than the carryover standard. However, their reported actual year-end carryover figures exceeded the standard several times during this time. For example, the Army ordnance activity group budgeted for 1.9 months of carryover at the end of fiscal year 2000, while the reported actual balance was 5.2 months—3.3 months higher than its budget estimate. The budgeted and reported actual year-end carryover balances for the Navy activities we reviewed have generally been less than the 3-month standard since fiscal year 1996. However, this result was achieved mainly due to the adjustments the Navy made in calculating its carryover balances, as discussed in the preceding paragraph.

We also reviewed the potential financial impact of reducing the amount of fiscal year-end carryover permitted by DOD policy. Our analysis showed that if a 30-day, 60-day, or 75-day carryover policy had been in effect during the fiscal year 2001 budget review process, the amount of budgeted customer orders could have been reduced by about $2.9 billion, $1.6 billion, or $1.0 billion, respectively. In discussing this matter with Army,

[3] The Congress affects a DOD entity's budget through the annual authorization and appropriations processes. In this report when we refer to the Congress reducing an entity's budget we mean statutory reduction in either the authorization act or appropriation act.

Navy, and Air Force officials, they stated that reducing the carryover standard to 30 days would have a number of potential negative impacts on the operations of the working capital fund activities. According to the military service officials, negative impacts could include (1) the refusal of new orders during the fourth quarter of the fiscal year to ensure that actual carryover levels do not exceed the 30-day standard, (2) insufficient work available during the first quarter of the next fiscal year, adversely impacting the planning and scheduling of work, and (3) working capital fund operating losses and a cash drain due to the lack of direct workload and revenue, which are necessary to finance salaries and overhead costs. However, because (1) DOD has not performed the analysis necessary to validate its existing 3-month carryover standard and (2) the actual impact would depend on a number of unknown factors—such as the amount and type of work requested by customers and the timing of the requests—it is difficult, if not impossible, to predict the operational impact of reducing the carryover levels.

We are making recommendations to the Secretary of Defense to improve DOD's management of the working capital fund carryover, including (1) determining the appropriate carryover standard for the depot maintenance, ordnance, and research and development activity groups based on the type of work performed by the activity group and its business practices, (2) clarifying DOD's policy on calculating months of carryover, (3) ensuring that the services calculate carryover in a consistent manner so that the carryover figures are comparable, and (4) providing better information on budgeted carryover. In its comments DOD agreed with our recommendations and briefly outlined its planned actions for addressing them.

## Background

A working capital fund relies on sales revenue rather than direct appropriations to finance its continuing operations. A working capital fund is intended to (1) generate sufficient revenue to cover the full costs of its operations and (2) operate on a break-even basis over time—that is, not make a profit nor incur a loss. Customers use appropriated funds, primarily Operations and Maintenance appropriations, to finance orders placed with the working capital fund. DOD estimates that in fiscal year 2001, the Defense Working Capital Fund—which consists of the Army, Navy, Air Force, Defense-wide, and Defense Commissary Agency working capital funds—will have revenue of about $74.3 billion.

The Defense Working Capital Fund finances the operations of two fundamentally different types of support organizations: stock fund activities, which provide spare parts and other items to military units and other customers, and industrial activities, which provide depot maintenance, research and development, and other services to their customers. Because carryover is associated only with industrial operations, this report discusses the results of our review on Defense's Working Capital Fund industrial operations.[4]

## What Is Carryover and Why Is It Important?

Carryover is the dollar value of work that has been ordered and funded (obligated) by customers but not yet completed by working capital fund activities at the end of the fiscal year. Carryover consists of both the unfinished portion of work started but not yet completed, as well as requested work that has not yet commenced. To manage carryover, DOD converts the dollar amount of carryover to months. This is done to put the magnitude of the carryover in proper perspective. For example, if an activity group performs $100 million of work in a year and had $100 million in carryover at year-end, it would have 12 months of carryover. However, if another activity group performs $400 million of work in a year and had $100 million in carryover at year-end, this group would have 3 months of carryover.

The congressional defense committees and DOD have acknowledged that some carryover is necessary at fiscal year-end if working capital funds are to operate in an efficient and effective manner. For example, if customers do not receive new appropriations at the beginning of the fiscal year, carryover is necessary to ensure that the working capital fund activities have enough work to ensure a smooth transition between fiscal years. Too little carryover could result in some personnel not having work to perform at the beginning of the fiscal year. On the other hand, too much carryover could result in an activity group receiving funds from customers in one fiscal year but not performing that work until well into the next fiscal year or subsequent years. By minimizing the amount of carryover, DOD can use its resources in the most effective manner and minimize the "banking" of funds for work and programs to be performed in subsequent years.

[4] The various components making up the Working Capital Fund are referred to by DOD as activity groups. For example, depot maintenance work is performed by the depot maintenance activity group. This group consists of individual depot maintenance activities that actually perform the work.

## DOD Does Not Have a Sound Analytical Basis for Its 3-Month Carryover Standard

DOD has a 3-month carryover standard for all but one working capital fund activity group,[5] but Office of the Under Secretary of Defense (Comptroller) and military service officials could not provide, and we could not identify, any analytical basis for this standard. We did not determine how much carryover individual activity groups would need in order to ensure a smooth flow of work at the end of the fiscal year. However, because the activity groups perform different types of work and have different business practices, the use of the same carryover standard for all activity groups is likely not appropriate.

Military service officials and activity group managers also questioned the use of a uniform standard. For example, because the Army's ordnance activity group is involved in the manufacture and assembly of munitions and weapon systems and requires a long lead time to obtain material, Army officials believe that group's carryover standard should be more than 3 months. Similarly, much of the work that customers request from Navy research and development activities is actually accomplished by contractors. Consequently, Navy research and development activity group managers believe they should be able to subtract work that is to be accomplished by contractors from their reported carryover balances or, if they must include this work in their totals, to have a longer carryover period.

A 1987 DOD carryover study also raised questions about the use of a uniform carryover standard. This study defined the optimum level of carryover as "the minimum amount of work needed in order to ensure that there is no interruption of the average work cycle." As part of its 1987 carryover study, DOD asked the military departments to provide information on their working capital fund activity groups. Specifically, for each activity group they were to provide (1) information on the types of services provided and (2) data on the average time between commencement and completion of projects. Data developed for Army, Air Force, and DOD-wide activity groups[6] showed that (1) the minimal carryover level varied significantly from one activity group to another and

[5]The one exception is that DOD established a 4.5-month carryover standard for the Air Force's contract depot maintenance operations.

[6]Neither the Navy nor the Marine Corps provided the data requested by DOD prior to the completion of the study.

(2) in some instances the minimal carryover level was considerably less than 3 months. However, the study noted that its analysis did not consider either administrative or material lead times and acknowledged that both of these factors could have a significant impact on carryover requirements.

When we discussed the 3-month carryover standard with officials of the Office of the Under Secretary of Defense (Comptroller), they acknowledged that they do not have an analytical basis for it. They informed us that the 3-month standard (1) was based on management judgment and that 3 months (one-fourth of the fiscal year) should be enough time to ensure a smooth flow of work during the transition from one fiscal year to the next, (2) had been in effect for many years, and (3) was reviewed during a 1996 DOD carryover study when DOD representatives visited various working capital fund activities to solicit the opinions of managers regarding the carryover standard and reviewed data substantiating those opinions. They also said that only in unusual situations should an activity group need more than 3 months of carryover. Finally, they questioned the benefit of performing an analysis for each activity group since it would require time and effort and would need to be updated periodically. However, without a sound analytical basis for carryover standards, we believe questions will continue to be raised about how much carryover is needed.

## The Military Services Have Inconsistently Implemented DOD's Carryover Guidance

The military services have not consistently implemented DOD's guidance for determining whether an activity group has exceeded the 3-month carryover standard. One contributing factor for the inconsistency is that DOD's guidance is vague concerning how certain items should be treated and/or calculated. Specifically, DOD's guidance is not clear regarding what is to be included or not included in the contractual obligation and the revenue dollar amounts used in the formula for determining the number of carryover months. As a result, year-end carryover data provided to decisionmakers who review and use this data for budgeting—the Office of the Under Secretary of Defense (Comptroller) and congressional defense committees—are misleading and not comparable across the three services. For example, our analysis of the fiscal year 2001 budget estimates showed that policy changes that affected the use of certain adjustments to the calculations had (1) no impact on the Air Force's reported year-end carryover because the Air Force did not make any adjustments, (2) reduced the Army's reported year-end carryover by less than 1 month, and (3) reduced the Navy's reported year-end carryover balance for some activity groups by 2 to 4 months. Further details on the

methods used by the services to calculate carryover can be found in appendix II.

## Defense Carryover Policy Is Based on 1996 Joint Study and Navy Concerns

Prior to 1996, if working capital fund activity groups' budgets projected more than a 3-month level of carryover, their customers' budgets could be, and sometimes were, reduced by the Office of the Secretary of Defense and/or congressional defense committees. However, in 1996, the Under Secretary of Defense (Comptroller) directed a joint Defense review[7] of carryover because the military services had expressed concerns about (1) the methodology used to compute months of carryover and (2) the reductions that were being made to customer budgets to help ensure that activity groups did not exceed the 3-month carryover standard.

Based on the work of the joint study group, DOD decided to retain the 3-month carryover standard for all working capital fund activity groups except Air Force contract depot maintenance.[8] For Air Force contract depot maintenance, it set a 4.5-month carryover standard because of the additional administrative functions associated with awarding contracts. Furthermore, based on the joint study group's work and concerns expressed by the Navy, DOD also approved several policy changes that had the effect of increasing the carryover standard for all working capital fund activities. Specifically, under the policy implemented after the 1996 study, certain categories of orders, such as those from non-DOD customers, and contractual obligations, such as Army arsenals' contracts with private sector firms for the fabrication of tool kits, can be excluded from the carryover balance[9] that is used to determine whether the carryover standard has been exceeded.

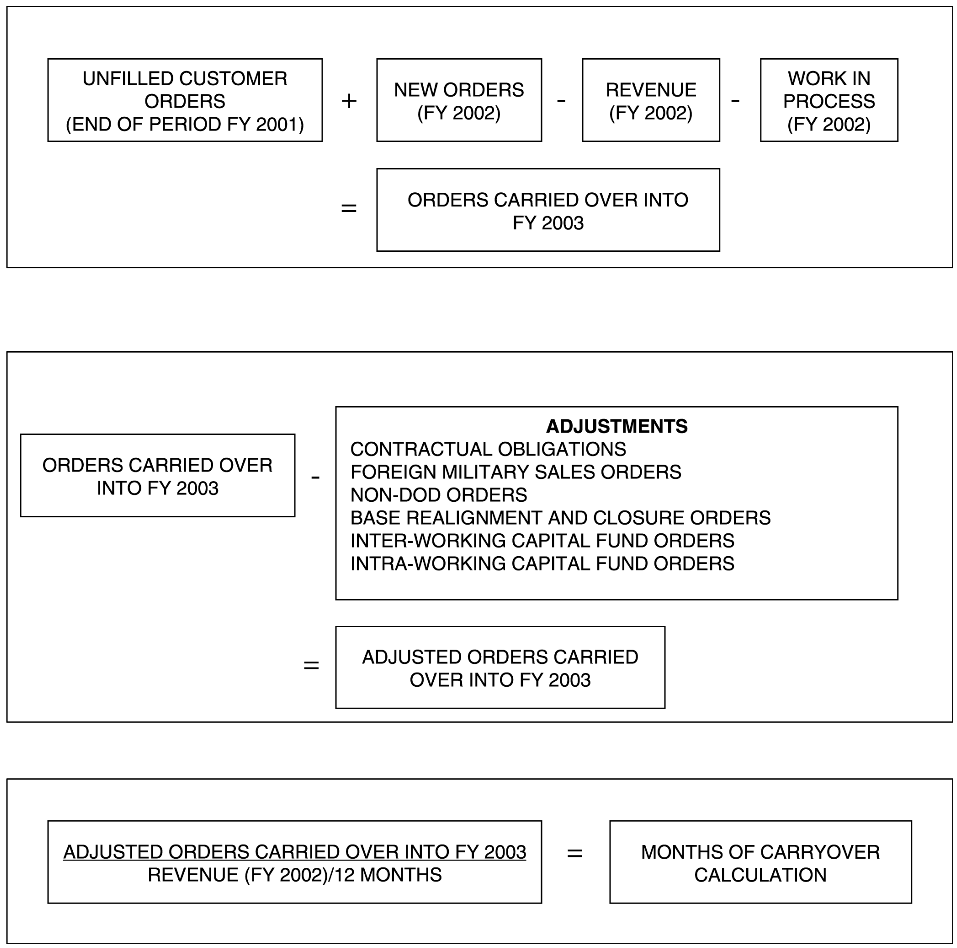
These policy changes were documented in an August 2, 1996, DOD decision paper that provided the following formula for calculating the number of months of carryover (see figure 1).

[7]This joint study group included representatives from the Office of the Secretary of Defense, the Office of the Joint Chiefs of Staff, and each of the military services.

[8]The Air Force is the only service that contracts out significant amounts of depot maintenance work through the working capital fund.

[9]Adjusted carryover is the obligated balance of budget authority carried over from one fiscal year to the next and adjusted for contractual obligations and certain categories of orders such as those from non-DOD customers.

Figure 1: DOD Carryover Computation Based on the Fiscal Year 2002 Budget




## Implementation Differences Distort Carryover Data and Can Affect Congressional Decisions

The impact of DOD's 1996 decision to exclude contract obligations and certain categories of orders from reported carryover varied significantly among the services. For example, our analysis of the military services' fiscal year 2001 budget estimates showed that this change (1) had no effect on the Air Force depot maintenance activity group's reported year-end carryover balance because the Air Force did not make any adjustments, (2) resulted in a $70.1 million reduction in the Army depot maintenance and ordnance activity groups' reported year-end carryover, and (3) as

illustrated in table 1, allowed the Navy to reduce its depot maintenance and research and development activity groups' reported year-end carryover by about $1.9 billion.

**Table 1: Navy Activity Groups' Fiscal Year-End 2001 Budgeted Carryover Before and After Adjustments**

Dollars in millions

| | Before adjustments | | After adjustments | |
|---|---|---|---|---|
| **Activity group** | **Dollars** | **Months** | **Dollars** | **Months** |
| Naval Air Warfare Center | $ 574.0 | 3.2 | $292.7 | 1.6 |
| Naval Surface Warfare Center | 1,106.0 | 5.8 | 506.3 | 2.6 |
| Naval Research Laboratory | 128.3 | 2.8 | 27.0 | 0.6 |
| Naval Undersea Warfare Center | 222.2 | 3.9 | 151.2 | 2.6 |
| Space & Naval Warfare Systems Center | 566.7 | 5.4 | 264.1 | 2.5 |
| Naval aviation depots | 450.7 | 3.1 | 299.0 | 2.0 |
| Naval shipyards | 733.9 | 4.7 | 356.8 | 2.3 |
| **Total** | **$3,781.8** | **N/A** | **$1,897.1** | **N/A** |

Source: Navy budget and accounting reports. We did not validate the information for accuracy.

Our work showed that these differences were due primarily to the fact that the military services have treated contract obligations differently when calculating carryover. This problem, in turn, is due to the fact that DOD has not provided clear guidance on whether (1) the revenue used in the carryover formula should be reduced when adjustments are made for contract obligations and (2) material requisitions submitted to DOD supply activities should be considered contract obligations. Because the Army and Navy are reducing the amount of carryover but not the amount of revenue, the number of months of carryover they are reporting is understated.

We found differences in the way the military services make adjustments for contractual services. DOD's formula for calculating months of carryover is based on the ratio of adjusted orders carried over to revenue. The formula specifies that carryover should be reduced by the amount of contractual obligations. However, the policy does not address whether downward adjustments for the revenue associated with these contractual services should also be made. Unless this is done, the number of months will be understated.

The Army and Navy reduced their carryover balances by the amount of contractual obligations, but they did not reduce the revenue associated with these contractual services. On the other hand, the Air Force depot maintenance activity group in effect did reduce the revenue associated

with contractual obligations because (1) it segregates its contract operations' carryover and revenue from its in-house operations' carryover and revenue and (2) DOD has established separate carryover standards for the Air Force in-house and contract depot maintenance operations.

The Air Force depot maintenance activity group's approach ensures that data on in-house operations is not distorted by data on contract operations. On the other hand, the Army and Navy's approach allows activity groups to reduce their reported months of carryover by simply increasing the amount of work contracted out. Our work showed that the months of carryover reported by the Army and Navy activity groups would more accurately reflect the actual backlog of DOD in-house work if adjustments for contractual obligations affected both contract carryover and contract revenue. In discussing this matter with officials from the Office of the Under Secretary of Defense (Comptroller), they stated that we had a valid point and indicated that DOD would need to review its carryover policy to determine whether it needs to be revised.

Similarly, we found that differences in the way the military services treat outstanding material requisitions[10] has a significant effect on the dollar value of carryover that is reported. Specifically, our analysis showed that Navy activity groups and some Army activities[11] consider material requisitions to be contract obligations and that they, therefore, subtract the dollar value of outstanding requisitions from their carryover balances. However, the Air Force depot maintenance activity group, which had about $448 million of material on requisition as of September 30, 2000, did not make any such adjustments. Office of the Under Secretary of Defense (Comptroller) officials informed us that outstanding material requisitions were not intended to be included as contractual obligations for carryover purposes. In fact, they told us that when the policy to allow carryover to be adjusted for contract obligations was established in 1996, the intent was that only contracts with private industry would be included as contract obligations when calculating the number of months of carryover.

The inconsistencies in the military services' implementation of DOD's 1996 guidance affected the actions that congressional decisionmakers took on

[10]Outstanding material requisitions are orders to buy inventory from DOD supply activities that have not been filled at fiscal year-end.

[11]Our work showed that there are significant implementation differences not only among the services but also among individual activities within the Army.

fiscal year 2001 budget estimates. For example, the Air Force's fiscal year 2001 budget showed that the unadjusted months of year-end carryover for in-house depot maintenance operations was 3.3 months. Because the 3-month carryover standard was exceeded, the Congress reduced the Air Force's Operation and Maintenance appropriation by $52.2 million. However, our analysis showed that the Air Force's estimate would have been less than DOD's 3-month standard if it had subtracted the dollar value of outstanding material requisitions from its carryover estimates—as the Navy does. Because the Navy adjusted its year-end carryover estimates for both contract obligations and certain types of orders, its reported year-end carryover balances were less than the 3-month standard. As a result no action was taken on the Navy's budget.

## Army and Navy Did Not Follow DOD Guidance on Calculating Carryover for Inter/Intra Fund Orders

DOD policy requires each individual working capital fund activity to record as carryover any unfilled work orders the activity has accepted. Some of these orders are received from other working capital fund activities. For example, a Navy working capital fund activity (activity 1) may perform part of the work a customer has ordered and "subcontract" part of the work out to another working capital fund activity (activity 2). In this situation, both activities—the activity originally accepting the customer order (activity 1) and the activity receiving part of the work to be performed (activity 2)—record the unfilled order as carryover. In order to eliminate any double counting of carryover, DOD's policy allows an activity, as shown in figure 1, to adjust or reduce its carryover for orders received from other working capital fund activities (inter/intra fund orders). However, Navy working capital fund activities and some Army activities categorized orders they sent to other working capital fund activities as contract obligations and used these obligations to reduce reported year-end carryover. As a result, not only did the Navy and Army eliminate the double counting of such orders, they eliminated all these orders from its calculation to determine the number of months of carryover and, thereby, did not follow DOD guidance on calculating carryover for inter/intra fund orders.

## Inaccurate Budget Estimates Further Complicate Review of Carryover Levels

Further complicating the congressional budget review of carryover is that some activity groups have underestimated their budgeted year-end carryover year after year, thereby providing decisionmakers misleading carryover information and resulting in more funding being provided than was intended. As previously discussed, the 3-month standard has never been validated and the services do not use the same method for calculating carryover. Therefore, the number of months of budgeted and actual carryover that the services have reported are not comparable. Nevertheless, each year, the services' budget submissions include information on budgeted and actual year-end carryover for each activity group. Decisionmakers in the service headquarters, Office of the Under Secretary of Defense (Comptroller), and congressional defense committees use this information to determine whether the activity groups have too much carryover. If the groups do, the decisionmakers may reduce the customer budgets that finance new orders.

Actual reported year-end carryover levels for the Army and Air Force depot maintenance activity groups and the Army ordnance activity group exceeded DOD's carryover standard many times during fiscal years 1996 through 2000.[12] Further, our analysis showed that in many of these instances, the budget estimate for year-end carryover was less than the DOD standard. If carryover estimates for the Army's activity groups and the Air Force's contract depot maintenance operations had been more accurate, the service headquarters, the Office of the Under Secretary of Defense (Comptroller), and/or the congressional defense committees might have taken action to reduce customer funding for new orders as has been done in the past.

### Army Reports Showed That Certain Activity Groups Exceeded the 3-Month Carryover Standard

Table 2 shows that the actual reported year-end carryover for Army's depot maintenance and ordnance activity groups exceeded the 3-month carryover standard consistently from fiscal year 1996 through fiscal year 2000. Table 2 also shows that the Army's budget consistently underestimated the amount of actual year-end carryover for each year from fiscal year 1998 through fiscal year 2000 for the two activity groups. Since the Army's budgeted year-end carryover exceeded the 3-month

[12] Navy budget and accounting reports showed that, with one exception, the Navy aviation depots, shipyards, and research and development activity groups' carryover balances have been less than or equal to the 3-month standard since fiscal year 1996 mainly due to the adjustments the groups made in calculating their carryover balances as discussed in the previous section.

standard for fiscal year 2001, the Department of Defense Appropriations Act, 2001, reduced the Army's fiscal year 2001 Operation and Maintenance appropriation by $40.5 million.

**Table 2: Number of Months of Fiscal Year-End Carryover Reported by the Army Depot Maintenance and Ordnance Activity Groups From Fiscal Year 1996 Through Fiscal Year 2001**

| | Depot maintenance | | Ordnance | |
|---|---|---|---|---|
| Fiscal year | Budget | Actual | Budget | Actual |
| 1996 | [a] | 3.6 | [a] | 6.8 |
| 1997 | [a] | 3.2 | [a] | 6.8 |
| 1998 | 2.6 | 3.4 | 3.0 | 5.6 |
| 1999 | 2.5 | 4.4 | 4.2 | 7.1 |
| 2000 | 2.9 | 4.2 | 1.9 | 5.2 |
| 2001 | 3.3 | [b] | 3.2 | [b] |

[a] Information was not available

[b] Information will not be available until after the end of fiscal year 2001

Source: Army budget and accounting reports. We did not validate the information for accuracy.

Concerning the Army depot maintenance activity group, Army officials provided us several reasons to explain why the reported actual year-end carryover exceeded the 3-month carryover standard and budget projections.

- For fiscal year 1998, Army officials could not explain why the actual fiscal year-end carryover for the depot maintenance activity group was above the 3-month standard and budget projection. They stated that the detailed data needed to determine the reasons had not been retained.
- For fiscal year 1999, Army officials stated that the depot maintenance activity group (1) received an inordinate number of new orders at year-end and (2) was unable to adjust its production schedules to mitigate the effect of the late receipt of new orders.
- For fiscal year 2000, Army officials stated that there were four reasons that the actual reported year-end carryover balance exceeded the standard and budget projection.
  - Some depots could not obtain the parts needed in a timely manner, so that less work was performed than planned.
  - Some depots did not accurately estimate the time and resources needed to complete jobs.
  - Emergency situations, such as unplanned orders to perform safety-of-flight work, delayed work on orders already accepted by the depots.

- The composition and size of the workload changed from the budget projections due to changes in customer funding and priorities.

Concerning the Army ordnance activity group which also exceeded the 3-month carryover standard, Army officials informed us that the group's primary focus is on manufacturing and that the 3-month standard should not apply. They stated that a longer carryover time frame is needed to accommodate the longer time needed for the manufacturing process and the long lead-time involved in buying certain types of material.

## Air Force Reports Showed That the Depot Maintenance Activity Group Exceeded the Carryover Standard

Table 3 shows that several times since fiscal year 1996 the Air Force's actual reported carryover for (1) in-house depot maintenance operations exceeded the 3-month standard and (2) contract depot maintenance operations exceeded the 4.5-month standard. Table 3 also shows that the Air Force's budget for contract depot maintenance underestimated the amount of actual year-end carryover for fiscal years 1997, 1999, and 2000. As stated previously, because the budgeted year-end carryover exceeded the carryover standard for fiscal year 2001, the Department of Defense Appropriations Act, 2001, reduced the Air Force fiscal year 2001 Operation and Maintenance appropriation by $52.2 million.

**Table 3: Number of Months of Fiscal Year-End Carryover Reported by the Air Force Depot Maintenance (In-House and Contract) From Fiscal Year 1996 Through Fiscal Year 2001**

| | Depot maintenance in house operations | | Depot maintenance contract operations | |
|---|---|---|---|---|
| Fiscal year | Budget | Actual | Budget | Actual |
| 1996 | 3.9 | 3.8 | 4.9 | 4.9 |
| 1997 | 2.9 | 3.5 | 3.4 | 3.9 |
| 1998 | 3.0 | 2.9 | 4.5 | 4.1 |
| 1999 | 2.5 | 3.3 | 4.1 | 6.2 |
| 2000 | 3.5 | 2.8 | 3.7 | 4.8 |
| 2001 | 3.3 | [a] | 6.4 | [a] |

[a] Information will not be available until after the end of fiscal year 2001

Source: Air Force budget and accounting reports. We did not validate the information for accuracy.

Air Force officials informed us that developing accurate carryover budgets and executing those budgets during the late 1990s was difficult because the depot maintenance activity group underwent significant downsizing. Specifically, the activity group (1) reduced maintenance personnel by more than one-third as it closed three repair centers and (2) realigned 40

percent of its in-house workload. In developing budgets for those years, the activity group's productivity estimates were optimistic resulting in the activity group accomplishing less work than budgeted, and, therefore, was unable to stay within the carryover standard. In addition to the productivity problem, the activity group could not always obtain the material it needed in a timely manner.[13] As a result, it could not complete work as scheduled and the amount of carryover increased.

In developing its fiscal year 2002 budget request, the Air Force determined that the initial year-end carryover budget estimate for its contract depot maintenance operations exceeded the 4.5-month carryover standard by $92.5 million. To help ensure that the actual carryover would not be over the 4.5-month standard at the end of fiscal year 2002, Air Force officials reduced the activity group's customers' budget request by $92.5 million. Thus, in theory, customers should order less work from the activity group in fiscal year 2002, resulting in less carryover than initially budgeted.

## Financial Impact of a Lower Carryover Standard

Our analysis showed that customer order levels would have been about $2.9 billion less than the amount budgeted if a 30-day carryover policy had been in effect during the fiscal year 2001 budget review process. Further, as previously discussed, the amount of carryover needed to ensure a smooth flow of work during the transition from one fiscal year to the next varies significantly from one activity group to the next. Military service officials and working capital fund managers stated that a 30-day carryover policy would have a potentially adverse effect on the operations of most working capital fund activities. However, because (1) DOD has not performed the analysis necessary to validate its existing 3-month carryover standard and (2) the actual impact would depend on a number of unknown factors—such as the amount and type of work requested by customers and the timing of the requests—it is difficult, if not impossible, to predict the operational impact of reducing the carryover standard.

If DOD were to reduce its carryover standard to less than 3 months, a corresponding reduction would occur in both the amount of carryover allowed and the level of customer orders accepted. As noted in the

[13]Our report entitled *Air Force Supply: Management Actions Create Spare Parts Shortages and Operational Problems* (GAO/NSIAD/AIMD-99-77, April 29, 1999) discusses this problem.

previous paragraph, our analysis showed that customer order levels would have been about $2.9 billion less than the amount actually budgeted if a 30-day carryover policy had been in effect during the fiscal year 2001 budget review process. If the standard had been reduced to 60 days or 75 days, projected customer order levels would have been about $1.6 billion or $1.0 billion less, respectively, than the amount budgeted. The amount of carryover exceeding 90 days was about $700 million.

Although they have no analytical data to support their views, working capital fund managers at the headquarters level believe a 30-day carryover policy would have the potential of significantly impairing their operations. Working capital fund officials at the activities we visited indicated that a 30-day policy would (1) restrict their ability to accept orders during the fourth quarter of the fiscal year as they act to ensure that actual carryover levels do not exceed the 30-day standard, (2) complicate the tasks of planning and scheduling work, and (3) create “pockets of inefficiency” where direct-labor employees are without work and must, therefore, charge their time to overhead. They also indicated that these problems, in turn, would adversely affect their ability to provide timely support to their customers, increase the unit cost of the work that is accomplished, and cause operating losses.

Our work showed that, because the amount of carryover needed to ensure a smooth flow of work varies significantly from one activity group to the next, the effect of a 30-day carryover standard on a group’s efficiency and effectiveness would likewise vary significantly. For example, in its August 1996 decision paper, which addresses the carryover standard, DOD points out that the Air Force’s contract depot maintenance operations could not operate with a 30-day standard because the average administrative time associated with awarding a contract is more than 30 days. Conversely, Navy records indicate that the Naval Research Laboratory’s actual reported carryover during fiscal years 1996 through 2000 averaged about 0.9 months, and laboratory officials indicated that these low carryover levels have not had an adverse impact on their operations.

Finally, our work indicates that the impact of a 30-day policy depends largely on what action DOD ultimately takes to ensure consistent carryover reporting. For example, at the end of fiscal year 2000, the Air Force depot maintenance activity group reported actual year-end carryover levels of 4.8 months for contract operations and 2.8 months for its in-house operations. However, if it had used the Navy’s carryover reporting policies and procedures, the activity group would have reported an overall carryover level of about 1.6 months. Conversely, although Navy

activity groups frequently reported actual year-end carryover balances of less than 2 months during fiscal years 1996 through 2000, their managers indicated that even a 3-month standard would not be enough if they implemented DOD's carryover formula in the same manner as the Air Force.

## Conclusions

Decisionmakers do not have the information they need to make informed decisions on fiscal year-end carryover balances because (1) there is no analytical basis for the 3-month carryover standard, (2) the services use different methods to calculate the carryover balances, and (3) some activity groups consistently underestimate their budgeted carryover when developing their budgets. Until these weaknesses are resolved, concerns will continue to be raised about whether an activity group has too much or not enough carryover. These concerns will affect not only the working capital fund activity groups' operations but also customer operations because they finance the orders placed with the working capital fund activities.

## Recommendations for Executive Action

We recommend that the Secretary of Defense

- direct the Under Secretary of Defense (Comptroller) to determine the appropriate carryover standard for the depot maintenance, ordnance, and research and development activity groups because these groups account for about 90 percent of the dollar amount of carryover. The carryover standard should be based on the type of work performed by the activity group and its business practices, such as whether it performs the work in-house or contracts it out. As part of this effort, DOD needs to have a sound analytical basis for determining the appropriate level of carryover.
- direct the Under Secretary of Defense (Comptroller) to clarify the carryover policy to obtain consistency in calculating the amount of carryover for use in determining whether the activity groups have exceeded the carryover standard. Specifically, in calculating the number of months of carryover, the policy needs to clarify (1) the type of obligations to be included in the contractual obligation category, such as contracts with private industry and outstanding material requisitions, and (2) that the revenue used must be adjusted for certain purposes, such as revenue earned for work performed by contractors. All internal and external reporting of carryover should be done using the same methodology.
- direct the Under Secretary of Defense (Comptroller) to ensure that the military services calculate carryover consistently during the budget review process so that the carryover figures are comparable.

- direct the Under Secretary of Defense (Comptroller) and the Acting Secretaries of the military services to enforce the current policy that specifies that one activity should report carryover on interfund and intrafund orders.
- direct the Acting Secretaries of the military services to use more realistic carryover figures in developing their budgets by considering historical actual carryover data.

## Agency Comments

In its comments on a draft of this report, DOD agreed with our five recommendations and stated that it will take actions in the near future to clarify the policies and formula to properly ascertain a uniform approach in examining the backlog of funded work in its Financial Management Regulations. In addition, DOD said it will revalidate the appropriate carryover standards that should be applied to the depot maintenance, ordnance, and research and development activity groups.

We are sending copies of this report to the Honorable Donald H. Rumsfeld, Secretary of Defense, and the Acting Secretaries of the Army, Navy, and Air Force. We will also make copies available to others upon request. Please contact Greg Pugnetti at (703) 695-6922 if you or your staff have any questions concerning this report. GAO contact and staff acknowledgments to this report are listed in appendix IV.

Gregory D. Kutz

Gregory D. Kutz,
Director, Financial Management and Assurance

David R. Warren

David R. Warren,
Director, Defense Capabilities and Management

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# Appendix I Scope and Methodolgy

To determine the reasons and the basis for DOD's 3-month carryover policy, we met and discussed the policy with officials from the Office of the Under Secretary of Defense (Comptroller), Army, Navy, and Air Force. We also requested and reviewed documentation and/or analysis that supported the rationale for the 3-month carryover standard. In addition, we obtained and analyzed DOD studies, including the 1996 carryover study and budget documents that discussed DOD's carryover policy and the need for a 3-month period. We did not determine how much carryover individual activity groups would need in order to ensure a smooth flow of work at the end of the fiscal year.

To determine if the services were calculating carryover in a consistent manner and, if not, the reasons for any differences, we obtained and analyzed the services' calculations for the (1) fiscal year 1996 through fiscal year 2000 reported year-end actual carryover balances and (2) fiscal year 1996 through fiscal year 2001 budgeted year-end carryover balances. We met with officials from the Army, Navy, and Air Force to discuss the methodology they used to calculate carryover. We obtained (1) explanations about why the services made adjustments in calculating the dollar amount of carryover balances as well as the number of months of carryover and (2) determined the impact of those adjustments on the carryover figures.

To determine if the military services' budgeted and reported actual carryover amounts exceeded the 3-month standard at fiscal year-end, we obtained and analyzed (1) budgeted year-end carryover data for fiscal year 1996 through fiscal year 2001 and (2) reported actual year-end carryover data for fiscal year 1996 through fiscal year 2000. When the budgeted and/or actual carryover data exceeded the 3-month standard, we met with responsible budgeting and/or accounting officials to ascertain why.

To determine whether applying the carryover authority to not more than a 30-day quantity of work would be sufficient to ensure uninterrupted operations at the working capital fund activities early in a fiscal year and what the impact on these activities would be if the carryover policy were reduced from 3 months to 30 days, we calculated what the potential financial impact on customer orders would have been if a 30, 60, 75, or 90-day carryover standard had been in effect for fiscal year 2001. We also met with (1) headquarters officials from the Office of the Under Secretary of Defense (Comptroller), Army, Navy, and Air Force and (2) Army, Navy, and Air Force officials at individual working capital fund activity groups and activities to obtain their views on what the impact on their operation would be if the carryover policy were reduced from 3 months to 30 days.

However, because (1) DOD has not performed the analysis necessary to validate its existing 3-month carryover standard and (2) the actual impact would depend on a number of unknown factors, such as the amount and type of work requested by customers and the timing of the requests, it is difficult, if not impossible, to predict the operational impact of reducing the carryover levels.

In performing our work, we obtained carryover information on the following Defense Working Capital Fund activity groups: (1) Air Force depot maintenance (in-house and contract), (2) Army depot maintenance, (3) Army ordnance, (4) Naval aviation depots, (5) Naval shipyards, and (6) Naval research and development. The Naval research and development activity group consists of the following five subgroups: Naval Air Warfare Center, Naval Surface Warfare Center, Naval Undersea Warfare Center, Naval Research Laboratory, and the Space and Naval Warfare Systems Center.

We performed our review at the following locations.

## Department of Defense

- Office of the Under Secretary of Defense (Comptroller), Washington, D.C.

## Air Force

- Air Force Headquarters, Washington, D.C.
- Air Force Materiel Command, Wright-Patterson Air Force Base, Ohio
- Oklahoma City Air Logistics Center, Tinker Air Force Base, Oklahoma
- Ogden Air Logistics Center, Hill Air Force Base, Utah
- Warner Robins Air Logistics Center, Robins Air Force Base, Georgia

## Navy

- Navy Headquarters, Crystal City, Virginia
- Naval Surface Warfare Center, Crystal City, Virginia
- Naval Surface Warfare Center, Carderock Division; Carderock, Maryland
- Naval Surface Warfare Center, Crane Division; Crane, Indiana
- Naval Surface Warfare Center, Dahlgren Division; Dahlgren, Virginia
- Naval Surface Warfare Center, Indian Head Division; Indian Head, Maryland
- Space and Naval Warfare Systems Command, San Diego, California
- Space and Naval Warfare Systems Center, San Diego, California
- Space and Naval Warfare Systems Center, Charleston, South Carolina
- Naval Research Laboratory, Washington, D.C.
- Naval Air Systems Command, Patuxent River, Maryland
- Naval Aviation Depot, Cherry Point; Cherry Point, North Carolina
- Naval Aviation Depot, North Island; San Diego, California

## Army

- Army Headquarters, Washington, D.C.
- Army Materiel Command, Alexandria, Virginia
- Army Communications-Electronics Command, Fort Monmouth, New Jersey
- Corpus Christi Army Depot, Corpus Christi, Texas
- Tobyhanna Army Depot, Tobyhanna, Pennsylvania

The reported actual year-end carryover information used in this report was produced from DOD's systems, which have long been reported to generate unreliable data. We did not independently verify this information. The Defense Inspector General has cited system deficiencies and internal control weaknesses as major obstacles to the presentation of financial statements that would fairly present the Defense Working Capital Fund financial position for fiscal years 1993 through 2000.

Our review was performed from September 2000 through April 2001 in accordance with U.S. generally accepted government auditing standards. However, we did not validate the accuracy of the accounting and budget information, all of which was provided by the Army, Navy, and Air Force. We requested comments on a draft on this report from the Secretary of Defense or his designee. We have reprinted the comments in appendix III of this report.

# Appendix II The Military Services Have Inconsistently Implemented DOD's Carryover Guidance

DOD's carryover guidance does not address how certain items should be treated and/or calculated and, as a result, it is a contributing factor to the military services' inconsistent implementation of DOD's formula for determining the number of months of carryover. This appendix discusses the different methods the services used to determine compliance with DOD's 3-month carryover standard.

## Air Force's Method of Determining Compliance With DOD's Carryover Standard

Prior to the fiscal year 2002 budget, the Air Force did not make any adjustments to its figures when determining the number of months of carryover and whether the Air Force had exceeded the 3-month standard. An Air Force official said they did not implement the 1996 carryover guidance sooner because the deductions would have had little or no impact on the number of months of carryover. Beginning with the fiscal year 2002 budget, the Air Force official informed us that they were making the adjustments so that the Air Force would be in compliance with DOD's 1996 carryover policy.

In making the adjustments for the fiscal year 2002 budget, the Air Force reduced its year-end carryover figure by the amount associated with certain types of orders, such as orders from foreign countries and non-DOD sources. However, unlike the Navy and Army, as discussed below, the Air Force (1) did not make adjustments for contractual obligations such as outstanding requisitions for material and (2) reduced the revenue figure used in the calculation by the amount of revenue related to those certain types of orders excluded from the carryover figure. An Air Force official told us that they adjusted the revenue figure so that the Air Force would be consistent in making the adjustments. That is, they reduced both the numerator (the carryover figure) and denominator (the revenue figure) part of the equation.

## Navy's Method of Determining Compliance With DOD's Carryover Standard

The Navy has been making the allowable adjustments to its year-end carryover figures since 1996.[1] The Navy has been reducing orders carried over into the next fiscal year for (1) carryover associated with certain types of orders, such as orders from foreign countries and non-DOD sources and (2) any contractual obligations incurred against those orders, which includes contracts with private industry, outstanding material

[1]The Navy began making adjustments in 1996, which affected the fiscal year 1998 budgeted carryover figures and the fiscal year 1996 actual carryover figures.

requisitions with DOD supply activities, and orders placed with other working capital fund activities.

However, unlike the Air Force, the Navy did not reduce or make any adjustments to the revenue figure used in the calculation. Because it did not adjust the revenue figure, the Navy's method resulted in a lower monthly carryover figure than did the method used by the Air Force. Navy officials informed us that they used total revenue in their calculation because total revenue represented the full operating capability of a given activity to accomplish a full year's level of workload. Further, the Navy's reason for not removing contract-related revenue from the denominator of the calculation was that the numerator of the calculation included carryover (funds) related to work for which contracts would eventually be awarded but which had not yet been awarded at fiscal year-end.

## Army's Method of Determining Compliance With DOD's Carryover Standard

The Army has also been making the allowable adjustments to its carryover figures since 1996.[2] That is, the Army has been reducing orders carried over into the next fiscal year for (1) carryover associated with certain types of orders, such as orders from foreign countries and non-DOD sources and (2) any contractual obligations incurred against those orders, which include contracts with private industry, outstanding material requisitions with DOD supply activities, and orders placed with other working capital fund activities. Like the Navy, the Army also did not reduce or make any adjustments to the revenue figure used in the calculation.

Army officials told us that they did not adjust the revenue figure because (1) DOD's guidance states that current year revenue should be used when calculating months of carryover and (2) doing so reflects the rate of actual workload execution for the entire year. However, in discussing this issue with Army headquarters and depot officials, they stated that it did not make much sense to adjust the carryover figure in the formula (numerator) for contractual obligations and other orders and not make a corresponding adjustment to the revenue figure in the formula (denominator) for the related revenue.

[2]The Army began making the adjustments in 1996, which affected the fiscal year 1998 budgeted carryover figures and the fiscal year 1996 actual carryover figures.

Further, Army working capital fund activities where we performed work did not all calculate carryover the same way. For example, at least one Army activity did not use contractual obligations when calculating the number of months of carryover, even though the activity had such obligations. In addition, another Army activity did not use contractual obligations when computing the months of carryover until recently when it calculated its actual carryover for fiscal year 2000.

# Appendix III Comments From the Department of Defense

OFFICE OF THE UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

COMPTROLLER
(Program/Budget)

MAY 11 2001

Mr. Gregory D. Kutz
Director Financial Management and Assurance
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Kutz:

This is the Department of Defense (DoD) response to the GAO draft report "DEFENSE WORKING CAPITAL FUND: Improvements Needed for Managing the Backlog of Funded Work", dated April 5, 2001 (GAO Code 924056/OSD Case 3070). The Department agrees with the five recommendations and will undertake in the near future, efforts to clarify in the Financial Management Regulations, as appropriate, the policies and formula to properly ascertain a uniform approach in examining the backlog of funded work. In addition, the Department will re-validate for depot maintenance, ordnance, and research and development activity groups, the appropriate standards that ought to be applied to these groups.

We appreciate the opportunity to review and comment on this issue.

Sincerely,

Bruce A. Dauer
Deputy Comptroller
(Program and Budget)

Attachment

**GAO DRAFT REPORT DATED APRIL 5, 2001**
**(GAO CODE 924056) OSD CASE 3070**

**"DEFENSE WORKING CAPITAL FUND: IMPROVEMENTS NEEDED FOR MANAGING THE BACKLOG OF FUNDED WORK"**

**DEPARTMENT OF DEFENSE COMMENTS TO THE GAO RECOMMENDATIONS**

**RECOMMENDATION 1:** The GAO recommended that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to determine the appropriate carryover standard for the depot maintenance, ordnance, and research and development activity groups since these activity groups have about 90 percent of the dollar amount of carryover. The GAO noted that the carryover standard should be based on the type of work performed by the activity group and its business practices such as performing the work in house versus contracting out the work. The GAO also noted that as part of this effort, DoD needs to have a sound analytical basis for determining the appropriate level of carryover.

**DOD RESPONSE: Agree with Recommendation 1**

**RECOMMENDATION 2:** The GAO recommended that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to clarify the policy to obtain consistency in calculating the amount of carryover for use in determining whether the activity groups have exceeded the carryover standard. The GAO noted specifically, in calculating the number of months of carryover, the policy needs to clarify (1) the type of obligations to be included in the contractual obligation category, such as contracts with private industry and outstanding material requisitions; and (2) that revenue adjusted for certain purposes, such as revenue earned for work performed by contractors, be used. Also the GAO noted that all internal and external reporting of carryover should be done using the same methodology.

**DOD RESPONSE: Agree with Recommendation 2**

**RECOMMENDATION 3:** The GAO recommended that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to ensure that the Military Services calculate carryover in a consistent manner during the budget review process so that the carryover figures are comparable.

**DOD RESPONSE: Agree with Recommendation 3**

**RECOMMENDATION 4:** The GAO recommended that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) and the Acting Secretaries of the Military Services to enforce the current policy that specifies that one activity should report carryover on interfund and intrafund orders.

**DOD RESPONSE: Agree with Recommendation 4**

**RECOMMENDATION 5:** The GAO recommended that the Secretary of Defense direct the Acting Secretaries of the Military Services to use more realistic carryover figures in developing their budgets by considering historical actual carryover data.

**DOD RESPONSE: Agree with Recommendation 5**

# Appendix IV GAO Contact and Staff Acknowledgments

## GAO Contact

Greg Pugnetti, (703) 695-6922

## Acknowledgments

In addition, Karl Gustafson, William Hill, Ron Tobias, and Eddie Uyekawa made key contributions to this report.

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